



# SENATE FISCAL AGENCY

## NOTES ON THE BUDGET AND ECONOMY

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### SCHOOL AID PRORATION EXPLAINED

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When the first four-year School Aid budget was enacted last summer, Public Act 297 of 2000 appropriated funding through fiscal year (FY) 2002-03 based on a revenue picture that was bright and virtually unprecedented in its growth. One year later, revenue growth has slowed dramatically, necessitating action by the Legislature to balance a projected FY 2001-02 deficit, or failing that, proration of School Aid payments by the Executive branch.

On June 13, 2001, the House began public deliberations on House Bill (H.B.) 4371. This bill is a "negative supplemental" designed to address a projected deficit in the School Aid Fund (SAF) of roughly \$175 million at the end of FY 2001-02, and a further \$388 million estimated SAF deficit at the end of FY 2002-03. On June 28, the House passed H.B. 4371, decreasing the projected deficit to \$28 million at the end of FY 2002-03.

The bill then was sent to the Senate, which passed its version of H.B. 4371 on July 11, with a projected deficit at the end of FY 2002-03 of \$54 million. The next day, H.B. 4371 was returned to the House, which adopted further amendments but then did not concur in the amended Senate version on final passage. Therefore, the bill was sent to a Conference Committee, where it awaits further action. The same day the bill was sent to conference, the Executive branch issued a proration notice for School Aid, as specified in the State School Aid Act.

According to language in Section 11(3) of the School Aid Act, if the amount appropriated in the Act exceeds the amount available from the School Aid Fund, then payments under each section funded by the SAF (except for certain obligations specifically exempted in Section 11(3) of the Act) must be prorated across the board on an equal percentage basis (MCL 388.1611). The Senate Fiscal Agency (SFA) interprets the Act to

mean that in addition to the specific obligations exempted from proration, programs supported by the General Fund also are protected from proration.

On July 12, 2001, the Governor, State Budget Director, and State Treasurer issued a package of statements describing an estimated 5% proration of payments under all sections in the School Aid Act, except for the obligation sections mentioned above, which must be paid in full. Unless the Legislature adopts and the Governor signs a new K-12 budget balancing next year's budget, the proration will be effective October 1, 2001, and will affect the 2001-02 fiscal year only. This means that all programs in place for the current fiscal year will remain funded at their currently enacted levels. (Unlike the proration scenario, both the House and Senate versions of H.B. 4371 would affect several programs in the current year.) The first payment for FY 2001-02 is scheduled to be made on October 19, 2001.

The School Aid Act specifies that if a proration becomes necessary, payments under certain sections of the Act must be made in full first, with payments under the remaining sections prorated on an equal percentage basis. The sections under which payments must be made in full are: **Section 11f** (*Durant* cash payments); **Section 11g** (*Durant* debt service payments); **Section 22a**

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(Proposal A Obligation payments); **Section 31d** (School Lunch payments); **Section 51a(2)** (Intermediate School District Special Education Headlee payments); and **Section 51c** (Local School District Special Education Headlee payments).

As previously indicated, combining the May 2001 Consensus revenue estimates with the currently enacted appropriations for FY 2001-02 yields a projected SAF deficit of \$175 million at the end of FY 2001-02. The Executive branch estimated that a 5% proration<sup>1</sup> would erase this deficit. However, this estimate was based on prorating sections funded either by the SAF or by the General Fund. The Senate Fiscal Agency's interpretation of the School Aid Act, however, holds that sections funded by the General Fund are not subject to the proration. Therefore, a proration of 5.1% of payments under all sections funded by the SAF that are not exempted under Section 11(3) would be necessary to achieve a \$175 million saving in FY 2001-02. Of course, either proration percentage could change based upon new consensus revenue estimates, or changes in projected expenditures out of next year's budget.

If proration occurs, individual districts will be affected differently, based on the funding "mix" of their foundation allowances and categorical payments received. A district whose foundation allowance consists primarily of State dollars will be more greatly affected than one whose foundation allowance relies heavily on local funding. This happens because the proration affects only the State funding of a school district, not the local funding. The foundation allowances

of public school academies (PSAs) are entirely State funded, since they are not allowed to levy mills for school operating purposes. Therefore, PSA foundations will face larger reductions compared with per-pupil funding in local school districts. (The SFA website includes a table listing each district's currently enacted FY 2001-02 foundation allowance, equity payment if applicable, and estimated reductions due to proration.)

If proration occurs in October, and a new School Aid budget is not enacted in order to avoid continued proration throughout FY 2001-02, then the SFA estimates that there will be a \$388 million deficit at the end of FY 2002-03. This estimate is based upon a comparison of enacted appropriations for FY 2002-03 and unofficial revenue estimates for the same fiscal year. This scenario would require an across-the-board projected proration of more than 11% to balance the FY 2002-03 budget, or would require the Legislature and Governor to enact a budget either appropriating additional dollars or cutting programs to eliminate the projected deficit.

There is a provision within Section 11(3) that allows the Legislature to enact additional appropriations to prevent a proration of School Aid. The additional amount necessary to fund the projected shortfall may come from the General Fund, Counter-Cyclical Budget and Economic Stabilization Fund, State School Aid Fund balance, or any other source approved by the Legislature. The Department of Treasury may not begin the proration of School Aid payments unless the Legislature fails to adopt the amount necessary to prevent the proration within the prescribed time period.

If the Legislature desires to avoid proration in the upcoming fiscal year, the chambers have until early October to adopt a bill providing sufficient revenues (either by appropriating additional dollars or by cutting already-enacted programs) to balance the fiscal year 2001-02 budget. If this does not happen and proration occurs beginning with the October 19, 2001 payment, the Legislature still could take action to restore funding after the proration has taken place. However, school districts will receive a prorated payment until such time as the Legislature

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<sup>1</sup>) The gross appropriation (excluding Federal funds) for FY 2001-02 enacted under Public Act 297 of 2000 is roughly \$11.38 billion; out of this, the total of the obligation payments that must be made first and in full as mentioned above (e.g., Sec. 22a, Sec. 51c) is an estimated \$7.88 billion. Thus, the remaining appropriations of approximately \$3.50 billion (\$11.38 billion minus \$7.88 billion) would be the amount that would need to be prorated. The result would be an across the board proration for the remaining sections of the School Aid Act of 5% (\$175 million divided by \$3.50 billion).

restores the amounts necessary to prevent further proration. The Legislature also could restore sufficient funding to repay school districts an amount equal to the amount that was reduced from all payments due to proration.

For more detail on the House- and Senate-passed versions of H.B. 4371, or an analysis of proration on Statewide appropriations in the FY 2001-02 School Aid Act, please visit the SFA website at [www.senate.state.mi.us/sfa/](http://www.senate.state.mi.us/sfa/).

**ELIMINATING STATE GENERAL FUND BUDGET DEFICITS:  
THE MICHIGAN SOLUTION**  
*by Gary S. Olson, Director*

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For the first time in the past 10 years, the Michigan Legislature during the 2001 legislative session was faced with the task of eliminating projected deficits in the State budget. Over the prior decade the Legislature was dealing with surplus revenues and eliminating budget deficits was not an issue. This shifting of budget-making decisions occurred quickly as a result of a slowdown in the Michigan economy which resulted in substantial downward revisions in the consensus revenue estimates. These downward revisions in the consensus revenue estimates resulted in projected deficits in the fiscal year (FY) 2000-01 and FY 2001-02 General Fund/General Purpose (GF/GP) State budgets. This article provides information concerning the action taken by the Legislature to eliminate the projected budget deficits and also discusses the budget problems that will face the Legislature as it develops an FY 2002-03 State budget.

**FY 2000-01 State Budget Deficit**

On May 15, 2001, the Consensus Revenue Estimating Conference convened and agreed to substantial downward revisions in the estimates of FY 2000-01 and FY 2001-02 GF/GP revenues. The change in the consensus revenue estimates resulted in a projected \$340.4 million FY 2000-01 GF/GP budget deficit. Table 1 provides a summary of the adjustments enacted by the Legislature to eliminate this projected deficit. These actions consisted of a combination of reductions in appropriations, refinancing of capital construction projects, the elimination of previously authorized departmental work projects, and a withdrawal from the Budget Stabilization Fund. The remaining \$1.5 million deficit will be eliminated by appropriation lapses at the close of the fiscal year.

**Table 1: FY 2000-01 Enacted Adjustments to Balance  
General Fund/General Purpose Budget  
(millions of dollars)**

<b>Projected Revenues:</b>	
Beginning Balance . . . . .	\$ 211.8
Consensus Revenue Estimate . . . . .	9,189.1
Subtotal Available Revenues . . . . .	9,400.9
Enacted Appropriations . . . . .	\$9,741.3
<b>Projected Year-End Balance . . . . .</b>	<b>\$(340.4)</b>
<b>Legislative Action to Balance Budget:</b>	
Positive Supplemental Appropriations (S.B. 283) . . . . .	\$(82.0)
Positive Supplemental Appropriations (S.B. 291) . . . . .	(7.0)
Negative Supplemental Appropriations (S.B. 283) . . . . .	83.7
Funding Shift on State Building Authority Projects . . . . .	211.2
Work Project Funding Lapsed to the General Fund . . . . .	56.0
Budget Stabilization Fund Withdrawal (S.B. 463) . . . . .	77.0
Total Actions to Balance Budget . . . . .	\$338.9
<b>Projected Year-End Balance . . . . .</b>	<b>\$(1.5)</b>

The direct appropriation adjustments consisted of both positive and negative supplemental appropriations. The positive supplemental appropriations, which resulted in a larger projected budget deficit, were primarily for expenditure items beyond the control of the Legislature. The two largest positive supplemental appropriations enacted were a \$35.5 million appropriation to the Family Independence Agency to offset the impact of Federal sanctions for the State's failure to comply with requirements involving a uniform child support collection system, and a \$21.3 million supplemental appropriation for the Department of State Police to match Federal disaster relief funding. Offsetting these positive supplemental appropriations was a total of \$83.7 million of negative supplemental appropriations. The vast majority of these appropriation reductions involved appropriations that otherwise would have lapsed at the close of the fiscal year. In general, these negative supplemental appropriations did not have an impact on the operation of State programs.

The largest action that was taken to eliminate the FY 2000-01 budget deficit was the refinancing of three previously authorized capital construction projects. These projects, which had been authorized to be financed with surplus GF/GP revenues, were switched to financing by the sale of State Building Authority bonds. This financing switch provided the budget with a one-time \$211.2 million GF/GP revenue transfer. These three capital construction projects were the Hall of

Justice, \$87.8 million; the forensic center at the Ypsilanti State Hospital, \$95.1 million; and the State Police communications system, \$28.3 million.

The final actions involving the FY 2000-01 GF/GP budget were the elimination of \$56.0 million of departmental work projects and a \$77.0 million transfer from the Budget Stabilization Fund to the General Fund. Work projects are prior-year appropriations that are allowed to carry-forward in order to complete action on a multiyear project. The elimination of these work projects allows these funds to be transferred to the General Fund budget and be used to reduce the projected budget deficit. The transfer from the Budget Stabilization Fund to the General Fund was the final action taken to eliminate the projected FY 2000-01 GF/GP budget deficit.

#### **FY 2001-02 Budget Deficit**

On February 8, 2001, Governor John Engler submitted to the Legislature his FY 2001-02 budget recommendations. These recommendations were based on consensus revenue estimates agreed to during January 2001. When the FY 2001-02 consensus revenue estimates were revised on May 15, 2001, the FY 2001-02 GF/GP appropriation recommendations of the Governor exceeded the revised consensus revenue estimates by \$514.3 million. The Legislature undertook a variety of budget adjustments to eliminate the budget deficit. Table 2 provides a summary of the actions taken to

<b>Table 2: FY 2001-02 Enacted Adjustments to Balance General Fund/General Purpose Budget (millions of dollars)</b>	
FY 2001-02 GF/GP Consensus Revenue Estimate .....	\$9,270.3
FY 2001-02 Governor's Original Appropriation Recommendation ...	\$9,784.6
FY 2001-02 Projected Deficit .....	<b>\$ (514.3)</b>
<b>Legislative Action to Balance Budget:</b>	
Reduction of Governor's Recommended Appropriations .....	\$209.2
Merit Award Trust Fund Transfer .....	72.5
Tobacco Settlement Trust Fund Transfer .....	10.0
Reduction of Revenue Sharing Increase to 1.5% .....	50.0
Treasury Technology Upgrade-Delinquent Tax Revenue .....	2.5
Tax Amnesty Program .....	15.5
Budget Stabilization Fund Withdrawal .....	155.0
Total Actions to Balance Budget .....	<b>\$514.7</b>
<b>Projected Year-End Balance .....</b>	<b>\$0.4</b>

eliminate the projected budget deficit. The adjustments included reductions to the Governor's original appropriation recommendations, the transfer of restricted funds to the General Fund budget, the enactment of a tax amnesty plan, and a withdrawal from the Budget Stabilization Fund.

The appropriation reductions, from the Governor's original budget recommendations, totaled \$209.2 million. These reductions applied to all of the State departments. The only budget area that did not receive a reduction in the GF/GP appropriation level recommended by the Governor was the GF/GP grant to the School Aid Fund. The overall budget for the School Aid Fund was reduced because of a reduction in estimated restricted School Aid Fund revenues. The level of the GF/GP appropriation reductions included in the final appropriation levels varied among the State departments. Tobacco settlement funds totaling \$82.5 million were transferred to the General Fund. This transfer included \$72.5 million of unallocated Merit Award Trust Fund revenues and \$10.0 million of Tobacco Settlement Trust Fund revenues that resulted from a \$10.0 million one-time reduction in the grant to the Life Science Initiative implemented by the Michigan Economic Development Corporation. Restricted State sales tax revenues of \$50.0 million were transferred to the General Fund as a result of a 1.5% overall cap on the level of appropriated State Revenue Sharing payments to cities, villages, townships, and counties. The final restricted revenue transfer to the General Fund was \$2.5 million of delinquent tax revenue available from a delay in the implementation of Department of Treasury technology upgrades. The overall budget deficit solution also included \$15.5 million of projected additional revenues from a tax amnesty plan that is expected to be implemented during the spring of 2002. The final method used to eliminate the projected budget deficit was a \$155.0 million transfer from the Budget Stabilization Fund to the General Fund.

### **FY 2002-03 Budget Outlook**

Most people might assume that the outlook for the FY 2002-03 State GF/GP budget will improve considerably if the economic performance of the State improves. Unfortunately, the FY 2002-03

State GF/GP budget is likely to be a very difficult budget to enact even if the performance of the Michigan economy improves significantly. This difficult budget scenario results from two previously enacted decisions that will significantly influence the FY 2002-03 GF/GP budget. These decisions are the continued phase-in of additional reductions in the rate of the State income and single business taxes and an enacted increase in the level of the GF/GP grant to the School Aid Fund.

The State income tax rate will drop from 4.2% to 4.1% on January 1, 2002, and to 4.0% on January 1, 2003. This rate reduction will result in an incremental FY 2002-03 GF/GP revenue loss of \$226.3 million compared with the revenue loss from the income tax rate reductions already built into the FY 2001-02 State budget. The State single business tax rate will drop from 2.0% to 1.9% on January 1, 2002, and to 1.8% on January 1, 2003. This rate reduction will result in an incremental FY 2002-03 GF/GP revenue loss of \$53.6 million from the single business tax rate reductions already built into the FY 2001-02 State budget. Therefore, the first \$279.9 million of FY 2002-03 GF/GP revenue growth is already committed to fund these enacted tax rate reductions.

The level of the GF/GP grant to the School Aid Fund also will be increasing in FY 2002-03 compared to the level of the grant built into the FY 2001-02 State budget. During FY 2001-02 the GF/GP grant to the School Aid Fund was appropriated at \$205.6 million. The Legislature already has enacted an FY 2002-03 School Aid Fund appropriation bill (Public Act 297 of 2000), which contains an FY 2002-03 GF/GP grant to the School Aid Fund of \$420.7 million. This represents an increase of \$215.1 million over the prior fiscal year.

In combination the incremental cost of the income and single business tax rate reductions and the increased level of the GF/GP grant to the School Aid fund will consume the first \$495.0 million of any FY 2002-03 GF/GP revenue growth. The first consensus estimate of FY 2002-03 GF/GP revenues will not be developed until January 2002. However, if one assumes that FY 2002-03 GF/GP revenues increase by 5.0% over the

current FY 2001-02 consensus revenue estimate, this will result in \$463.5 million of increased FY 2002-03 GF/GP revenues. Therefore, the estimated revenue growth, assuming a moderate rate of economic improvement, already will be more than consumed by the tax rate reductions and the School Aid Fund grant increase.

Table 3 provides a summary of the overall problems that the State will be dealing with during the debate on the FY 2002-03 budget. As previously discussed, the projected GF/GP revenue growth of \$463.5 million is more than offset by the \$495.0 million cost of the tax cuts and the increased GF/GP grant to the School Aid Fund. In addition, the Senate Fiscal Agency has identified four additional budget items that will be very difficult to avoid. The first is a \$100.0 million GF/GP budget increase in the Medicaid program resulting from a decline in the State's Federal Medicaid match rate. This rate is already established for FY 2002-03 and the GF/GP contribution to the Medicaid program will have to increase by \$100.0 million in order to support the program that is being funded for the current year. This \$100.0 million increase in the GF/GP contribution to the Medicaid program does not include any cost increases associated with expected inflationary pressures affecting the

program. Second, the Department of Corrections budget is expected to increase by at least \$60.0 million reflecting projected population and cost increases. This expenditure could be avoided only by significant policy changes that would reduce prison sentences. The third major cost increase that will have to be built into the FY 2002-03 State budget is a \$40.0 million increase for debt service payments on State Building Authority construction projects. The final item is a \$100.0 million cost associated with providing economic cost increases to State agencies. This includes the salaries of State employees, fringe benefit costs, and other expenses such as utilities. These types of economic expenses will have to be covered in the budget or program reductions will occur to provide this funding.

As illustrated in Table 3, \$795.0 million of FY 2002-03 GF/GP expenditure items have been identified, while only \$463.5 million of additional revenue will be available if the State's economy grows at a moderate rate. This means that funding for increases in all other budgets such as Higher Education, Community Colleges, Community Health and Capital Outlay, will be in question. As a result of these circumstances, the FY 2002-03 GF/GP State budget will be another major challenge for the Legislature to face.

<b>Table 3: FY 2002-03 General Fund/General Purpose Budget (millions of dollars)</b>	
FY 2001-02 Consensus Revenue Estimate .....	\$9,270.3
FY 2002-03 Projected Revenue Estimate (5.0% Growth) .....	\$9,733.8
Projected FY 2002-03 Increased Revenues for Expenditures .....	<b>\$ 463.5</b>
<u>FY 2002-03 GF/GP Enacted Budget Increases:</u>	
Incremental Cost of Income Tax Rate Reduction .....	\$ 226.3
Incremental Cost of Single Business Tax Rate Reduction .....	53.6
Increased GF/GP to School Aid Fund .....	215.1
Total Enacted Budget Increases .....	<b>\$ 495.0</b>
<u>Other Potential Budget Increases:</u>	
Medicaid Match Rate .....	\$ 100.0
Corrections Operating Increase .....	60.0
State Building Authority Debt Service .....	40.0
Economic Increases in Departments .....	100.0
Total Other Potential Budget Increases .....	<b>\$ 300.0</b>
Total Enacted and Potential Budget Increases .....	<b>\$ 795.0</b>
Budget Increases Compared with Available Revenues .....	<b>\$(331.5)</b>
Senate Fiscal Agency, June 7, 2001	

**BUILD MICHIGAN II AND  
GRANT ANTICIPATION REVENUE VEHICLES  
by Craig Thiel, Fiscal Analyst**

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Under Governor Engler's Build Michigan II program introduced in 1997, the Michigan Department of Transportation (MDOT) committed to having 95% of the freeways and 85% of the nonfreeways, pavements, and bridges in "good" condition by the year 2007. The original financing plans for this infrastructure investment program called for a pay-as-you-go approach, relying on permanent revenue increases primarily from a hike in the State gasoline tax and additional Federal highway funding under the Transportation Equity Act of the 21<sup>st</sup> Century, commonly referred to as TEA-21. Based on four years of funding experience under TEA-21 and rising road and bridge construction costs, MDOT has decided to supplement existing resources with debt financing to deliver on its Build Michigan II promise by 2007.

In July 2001, the Michigan Department of Transportation issued \$400 million in short-term notes to address the shortfall in Federal highway funds and to advance and accelerate the completion of the Build Michigan II program. Through the use of an innovative debt-financing strategy allowed under TEA-21, MDOT is able to pledge future Federal highway funds to cover current debt service costs. This type of borrowing effectively allows MDOT to front-load the Build Michigan II program by providing the State with a portion of its future Federal highway funds today.

Accelerating the program will allow MDOT to avoid inflationary construction cost increases associated with some of its larger projects; however, MDOT will be faced with increased debt financing costs of about \$68 million over the life of debt repayment. Borrowing for Build Michigan II also comes on the heels of MDOT's issuance of \$308 million in long-term debt as the first phase of Governor Engler's plan to issue an estimated \$900 million in long-term debt for Build Michigan III.

**The Need for Short-Term Borrowing**

Traditionally, MDOT has used a combination of long-term borrowing and pay-as-you-go financing to fund State transportation projects. While the State of Michigan has issued general obligation short-term debt to meet its cashflow needs in the past, MDOT has never issued short-term debt for transportation purposes. To date, the Build Michigan II plan has relied exclusively on the permanent revenue increases from a 4-cent State gas tax increase and additional Federal revenue from TEA-21 to finance State transportation projects. However, the Build Michigan II schedule, combined with estimated Federal revenue shortfalls and rising project cost increases, has resulted in estimated funding shortages during the next few years.

The Michigan Department of Transportation estimates a shortfall in Federal highway funds based on the first four years of funding under TEA-21. Although TEA-21's minimum guarantee provision ensures that each state will receive annual apportionments of not less than 90.5% of its share of contributions to the Highway Trust Fund, Congress annually determines obligation limitations which effectively cap reimbursement levels to each state. Table 1 lists MDOT's share of apportionments and obligation authority under TEA-21 for Federal fiscal years 1997-98 through 2002-03 (projected).<sup>1)</sup> Through fiscal year (FY) 2000-01, MDOT has received nearly \$300 million less in Federal obligation authority compared with apportionments under TEA-21. According to MDOT, this Federal revenue shortfall threatens its ability to meet the Build Michigan II commitments by 2007.

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<sup>1)</sup> "Apportionment" is the amount funding designated to a state pursuant to a formula in an authorization statute (e.g., TEA-21), whereas "obligation authority" is the overall amount of funding that Congress, through the appropriations process, authorizes states to obligate in an individual year.

**Table 1: MDOT Apportionment and  
Obligation Authority under TEA-21  
Federal Fiscal Years 1998 through 2003  
(millions)**

Fiscal Year	Apportionment	Obligation Authority	Difference
1998	\$514.6	\$472.3	\$(42.3)
1999	656.5	567.1	(89.4)
2000	719.4	631.8	(87.6)
2001	757.3	671.1*	(86.2)
2002*	772.4	684.5	(87.9)
2003*	787.9	698.2	(89.7)

\* Projected

Source: Michigan Department of Transportation

In addition to fewer Federal funds, road construction costs over the past five years have increased more than expected, thereby further reducing the resources available to MDOT. According to U.S. Bureau of Labor Statistics data, annual average highway and street construction costs have increased 11.8% from 1996 to 2000. This increase is compared with an increase of 5.1% in the producer price index over the same period.<sup>2)</sup> Despite these pressures on resources, MDOT has continued with its commitments under the Build Michigan II. Without additional resources, however, MDOT would be forced to modify either the schedule or the scope of the Build Michigan II program.

### **Grant Anticipation Revenue Vehicles**

The expected funding shortage has forced MDOT to explore alternative financing strategies for Build Michigan II. Given Michigan's favorable bond ratings and the relatively attractive interest rate climate, MDOT decided that short-term borrowing will provide the needed resources today to address its short-term funding deficits. Bonding also will allow MDOT to accelerate some costly, high-profile projects, thereby avoiding future increases in construction costs.

<sup>2)</sup> The producer price index measures the price of finished goods at the wholesale level, before they are offered for sale at the retail level.

Specifically, MDOT will use an innovative borrowing strategy allowed under TEA-21 called Grant Anticipation Revenue Vehicles (GARVEEs). Unlike previous transportation borrowing which provided additional resources for state infrastructure investment, GARVEEs do not represent additional revenue but provide a mechanism to receive tomorrow's Federal revenue today. This financing instrument also requires future Federal highway funds to be set aside for debt repayment, rather than highway and/or bridge construction. Therefore, short-term borrowing does not solve the long-term funding shortage MDOT has been experiencing under TEA-21, but it does enable MDOT to leverage its future Federal highway funds in order to address its current cash deficit.

Grant Anticipation Revenue Vehicles are debt-financing mechanisms that allow states to fund transportation projects based on expected receipt of future Federal funds. Specifically, GARVEEs are either long-term (i.e., bonds) or short-term (i.e., notes) debt instruments backed by a jurisdiction's pledge of future Federal highway funds to repay the principal, interest, and other costs associated with debt issuance. As well as allowing states to leverage their Federal highway funds, GARVEEs provide another alternative to pay-as-you-go transportation financing.

Changes in Federal law during the mid- and late 1990s gave states more flexibility in the use of their Federal highway funds for debt financing and resulted in increased use of GARVEEs. Prior to 1995, states could use Federal highway funds only to cover the principal portion of debt service costs. This restriction limited a state's ability to leverage Federal funds for debt financing, as the predominant component of debt service costs during the early years of debt retirement is the interest payments. The National Highway System Designation Act of 1995 authorized states to use anticipated future Federal funds to cover the various cost components of debt financing. This significant change was incorporated into TEA-21 in 1997.

Federal law authorizes two types of GARVEEs: direct and indirect. In order to qualify for direct GARVEE financing, a project must be approved by the Federal Highway Administration (FHWA)



as an "advance construction" project.<sup>3)</sup> The debt service costs on direct GARVEE instruments are repaid by anticipated future Federal funds for one or more *specific* projects and are paid directly by the FHWA. Indirect GARVEEs are more flexible than direct ones. Projects financed with indirect GARVEEs do not have to be designated as advance construction. Also, the debt service costs on these instruments are repaid from a state's share of Federal funds that a state anticipates receiving as reimbursement for highway projects other than those being funded with the GARVEE proceeds. Similar to other Federal transportation programs, GARVEE-financed projects are subject to the general 80-20 Federal-state match requirements for repayment of the bond-related costs.

#### **State of Michigan Grant Anticipation Notes**

Section 18I of Public Act 51 of 1951 (P.A. 51) authorizes the State Transportation Commission to issue notes in anticipation of the receipt of grants from the Federal government and to pledge the proceeds of such grants for the payment of the principal, interest and redemption premiums on such notes. In July 2001, MDOT issued \$400 million in indirect GARVEEs in the form of short-term grant anticipation notes, or GANs. These notes are separate from State Trunkline Fund debt instruments and do not count against the debt-service limitation contained in P.A. 51. These notes are payable solely from the State's share of Federal highway reimbursements under TEA-21 or its successor.

The GANs will provide financing to advance and accelerate the completion of the Build Michigan II program. Proceeds from the notes will support expenditures for a variety of State road and bridge projects throughout various Michigan counties. All of the candidate projects have been designated by the FHWA as advance construction projects.

<sup>3)</sup> The "advance construction" designation preserves a project's future eligibility for Federal assistance without obligating the full Federal share of costs at the beginning of the project. This allows states to begin a project with non-Federal resources and still remain eligible for reimbursement for the Federal share of the project.

Although principal payments on the notes are not required until 2005, interest payments on the notes will begin immediately. Interest on the notes will be calculated on a weekly basis and fluctuate accordingly, although all debt service payments will be made on a monthly basis. All of the outstanding notes are required to be retired by September 2008. The total estimated costs associated with issuing \$400 million in short-term notes will be \$468 million (\$400 million in principal and \$68 million in interest). Annual principal and interest payments will be covered exclusively from the State's share of Federal highway funds. In nominal terms, the estimated \$68 million in interest expenses will effectively reduce the amount of Federal resources available for actual highway construction over the life of debt repayment. However, the benefits to the motoring public from accelerating the program and the savings associated with avoiding construction cost increases could outweigh the \$68 million in debt financing costs. At the present time, it is unknown how debt financing will affect the level of Federal funds available for actual construction.

As required for State Trunkline Fund bonds, authorization for MDOT to make debt service payments for the GANs will have to be contained in an appropriations act. The FY 2001-02 MDOT budget provides \$10 million in Federal highway funds to repay the debt service on the GANs in that year.

Several states have taken advantage of GARVEEs and other innovative financing mechanisms authorized under TEA-21 to address transportation demands in their states, each tailoring the chosen instrument to meet specific needs. A number of states, including Arizona, Arkansas, Colorado, Massachusetts, Mississippi, New Jersey, New Mexico, and Ohio, have used GARVEEs to finance major construction projects, while many others are considering the use of this unique instrument. Based on other states' experience to date, the bond market has viewed GARVEEs favorably, despite the fact that they are riskier than general obligation borrowing. The use of these instruments helps states accelerate construction, adds to their financing options, and may lower financing costs by improving bond ratings. Michigan's use of GANs to manage its cash flow and to accelerate its transportation

investment program represents another example in a growing trend of states' use of innovative transportation financing.

### **Conclusion**

Short-term borrowing will allow MDOT to address its expected Federal cash flow deficit, accelerate the Build Michigan II program, and still complete the program by the promised 2007 date. However, Michigan will use an estimated \$68 million in Federal highway funds to repay interest expenses over the next seven years; this funding (in an amount depending on inflation) therefore will not be available for highway and bridge construction. The Department will have to weigh these direct costs against the benefits of avoiding inflationary pressures and the indirect benefits to the motoring public from completing jobs early, reducing congestion, and improving convenience.

Michigan's plans to leverage its Federal highway funds in a new way entails certain risks. First, debt service payments are required until September 2008; however, the current Federal highway aid program, TEA-21, is authorized only through 2003. Although there is a history of 80-plus years of Federal aid for highways, the level of funding Congress will authorize in the next Federal aid program is unknown. Second, Michigan's share of the Federal aid program is subject, to some extent, to annual appropriations by Congress, which could affect Michigan's ability to cover debt service costs. Finally, front-loading the Build Michigan II program could jeopardize future projects should State transportation revenues decline while certain Federal funds are already earmarked for annual debt service costs on the GANs.

Furthermore, the use of GANs to finance Build Michigan II projects is another example of Michigan's use of debt financing to fund highway and bridge construction. At the end of FY 1999-2000, the State had \$633 million in outstanding long-term STF bonds. In FY 2000-01, the State added to this figure when it issued \$308 million in STF bonds as part of the planned \$900 million long-term borrowing for the Build Michigan III program. Some might argue that borrowing, and specifically the GANs, makes good financial sense given Michigan's favorable credit ratings

and the current interest rate climate. Others may object to further debt-financing and contend that transportation investment should be based on current revenues rather than borrowing, which draws too many resources away from annual construction programs to satisfy debt retirement costs. Ultimately, State policy-makers must decide whether current revenues are sufficient to meet the highway and bridge investment needs of today, or whether further borrowing should be used to provide the resources for highway and bridge infrastructure investment.